



Directorate of
Intelligence

~~Secret~~

25X1

Egypt: Financial Outlook and Implications for the United States

25X1

An Intelligence Assessment

~~Secret~~

NESA 87-10035
July 1987

Copy 341

Page Denied



Directorate of
Intelligence

Secret

25X1

Egypt: Financial Outlook and Implications for the United States

25X1

An Intelligence Assessment

This paper was prepared by [redacted] Office
of Near Eastern and South Asian Analysis. It was
coordinated with the Directorate of Operations.
Comments and queries are welcome and may be
directed to the Chief, Arab-Israeli Division,
NESA, [redacted]

25X1

25X1

Reverse Blank

Secret

NESA 87-10035
July 1987

Secret

25X1

Egypt: Financial Outlook and Implications for the United States

25X1

Key Judgments

*Information available
as of 1 June 1987
was used in this report.*

The outlook for Egypt's foreign payments over the next year appears to have brightened considerably. Movement toward a more realistic exchange rate, higher oil revenues, and increased assistance from the Gulf Arab states will help ease pressure on scarce government foreign currency assets. In addition, implementation of an International Monetary Fund-supported standby program has provided additional financial assistance and significant debt relief.

25X1

Despite these favorable circumstances, the basic problems facing the economy have not been resolved, and implementation of reforms will not eliminate the foreign payments gap. Nor do measures taken thus far meet the need to shift investment resources from the public sector to more productive economic activity. Moreover, Cairo's cumbersome and cautious political decisionmaking process, as well as regime concerns about political stability, will almost certainly lead to procrastination and loss of critical momentum on economic reform.

25X1

There is a better-than-even chance that the Mubarak regime will be able to muddle through the next year without a financial crisis, though at the price of substantially higher inflation than the 15- to 20-percent rate that has characterized the past several years. Only if Egypt falls out of compliance with its IMF-supported standby program and international oil prices dip below \$15 per barrel, both unlikely developments, would major economic difficulties recur over the near term.

25X1

As a result of reforms already enacted, living standards for middle- and lower-middle-income groups are likely to decline over the next year but probably not enough to provoke serious political unrest. The Egyptian Government will closely monitor the impact of its economic adjustment measures on public opinion and will almost certainly slow the pace of reform or even retract measures if the political risks are deemed too high.

25X1

The probability that over the next year Cairo will remain in compliance with the IMF-supported adjustment program is considerably better than even. Egypt's major Western partners, however, will have to maintain pressure on Cairo to ensure forward momentum, as Cairo's propensity will be to backslide on economic reform. The most likely prospect is for periodic breakdowns in the IMF-Egyptian dialogue, short of a formal suspension of

Secret

25X1

the standby agreement, which could further delay disbursements of multilateral assistance and heighten investor concern that the economy is again adrift.

25X1

Egypt, in any case, will look to the United States for significant new commitments of financial assistance. Even in the most trouble-free scenario, Cairo faces an \$800 million financing gap. Arab assistance conceivably could close this gap, but Egypt probably will turn initially to the United States for additional support and for further relief on its military debt. The linkage of US assistance to Egypt's performance on economic reform may exact a growing cost on larger bilateral ties. US pressure may even become counterproductive over the near term if Mubarak's growing concern with domestic stability is matched by strong Arab financial support.

25X1

Secret

Secret

25X1

Contents

	<i>Page</i>
Key Judgments	iii
From Prosperity to Foreign Payments Crisis	1
Struggling Toward a Standby Arrangement	1
Assessing the Reform Program	3
Can Egypt Muddle Through? Key Variables	4
Outlook and Domestic Consequences	7
Implications for the US-Egyptian Relationship	9

Secret

25X1

Egypt: Financial Outlook and Implications for the United States

25X1

From Prosperity to Foreign Payments Crisis

Beginning in the mid-1970s and lasting into the early 1980s, Egypt experienced a period of unparalleled growth and prosperity. Large inflows of foreign assistance, sharply rising earnings from oil exports, worker remittances, and tourism, and domestic policies that encouraged private enterprise contributed to high rates of growth and improved foreign payments balances. The majority of Egyptians, only peripherally affected by this influx of foreign earnings, greatly benefited from the government's having the wherewithal to maintain and expand a pervasive system of subsidies and price controls.

The growth in foreign exchange receipts, however, masked major defects in the economy. Oil exports aside, Egypt was basically uncompetitive in world markets. Its economy was characterized by low productivity and structural inefficiencies that discouraged production and investment and encouraged consumption and imports. Overvaluation of the exchange rate that made Egyptian goods uncompetitive, together with rigid controls on internal marketing that provided little incentive for farmers to produce foodstuffs, helped turn the country within the span of a decade from a net food exporter to a nation dependent on foreign suppliers for more than half of its food needs.

Egypt's foreign payments position began to weaken in the early 1980s as a result of declining oil prices, stagnant nonoil exports, soaring import growth, and a rapidly expanding debt service burden. Egyptian officials responded to the threat by introducing a series of modest economic reforms, including gradual price increases for some goods and services and higher procurement prices for many agricultural crops. In general, these reforms have not sufficiently stimulated production or stemmed the deterioration in Egypt's foreign payments account.

During fiscal year (FY) 1986,¹ Egypt's foreign payments position suffered further setbacks. Hard currency earnings plummeted early in the year, following the dramatic decline in world oil prices. A rigid oil-pricing policy also contributed to Cairo's revenue problem by consistently keeping Egyptian crude oil overpriced in a downward trending market.

25X1

The precipitous decline in oil revenue coincided with a drop in earnings from other major sources of foreign currency. Although it is not clear that total remittances fell, remittances accessible to the government substantially declined. Officially recorded remittances from expatriate workers declined, from \$3.5 billion in FY 1985 to \$2.6 billion in FY 1986.² The widening gap between the best government-offered exchange rate and the free market rate helped to channel remittances away from government coffers.

25X1

25X1

25X1

25X1

Tourism revenues also tumbled as a result of the police riots in February 1986 and the publicity surrounding terrorist incidents in the Middle East. Official Egyptian data show tourist earnings off 43 percent during the first half of 1986 as compared with the same period in 1985. Other foreign exchange earnings, including strong Suez Canal revenues, were insufficient to compensate for the shortfall caused by lower oil revenues and remittances.

25X1

25X1

Struggling Toward a Standby Arrangement

The tenuousness of Egypt's economic position became clear to the Mubarak government by mid-1986. At that time, the decision was made to seek a standby arrangement with the International Monetary Fund (IMF) despite serious

25X1

¹ Fiscal period ending 30 June of the stated year.

25X1

² The US Embassy estimates that unrecorded flows into foreign currency free accounts may have totaled \$860 million in FY 1986. In addition, unrecorded worker remittances funding workers' imports may have totaled \$400-600 million.

25X1

25X1

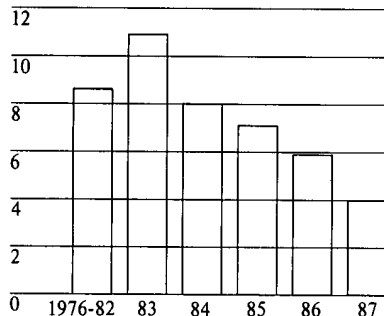
Secret

Figure 1
Egypt: Selected Economic Indicators, 1976-87^a

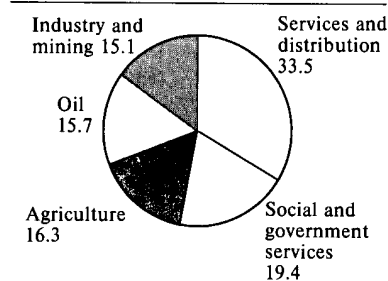
Note scale change

Real GDP Growth

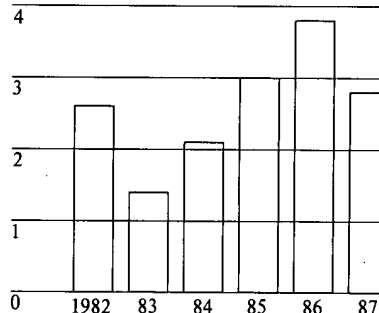
Percent

**Composition of GDP, 1985^b**

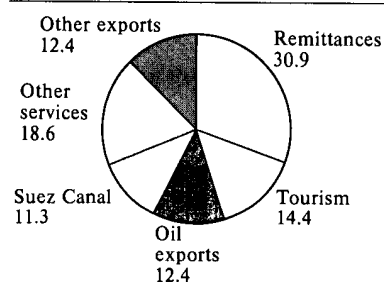
Percent

**Current Account Deficit**

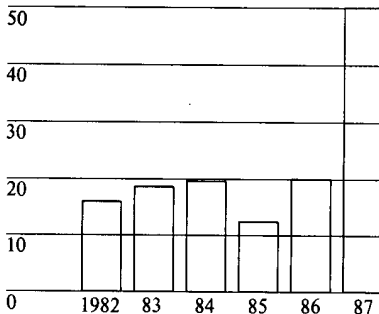
Billion US \$

**Composition of Foreign Earnings, 1987^c**

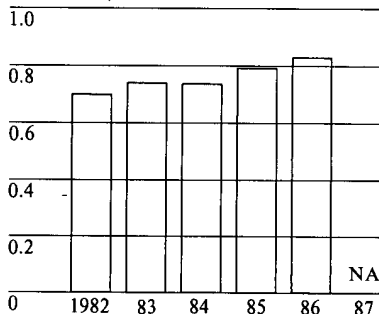
Percent

**Consumer Price Growth**

Percent

**Foreign Exchange Reserves**

Billion US \$



^a Data for fiscal period ending 30 June of the stated year. Data for 1987 are estimated.

^b Total=US \$ 18.5 billion converted at 1.35 £ E per US \$.

^c Total=US \$ 9.7 billion.

313400 7-87

25X1

reservations by some in the government.³ Negotiations proved long and difficult, with Cairo successfully

³ Standby arrangements are formal agreements concluded between the IMF and member countries facing large foreign payments disequilibrium. In exchange for specific economic adjustments that the country agrees to undertake within a fixed time schedule, the IMF provides funds that can be used to ease the adjustment process as the program proceeds and as performance targets are met. In addition, an IMF-endorsed standby arrangement usually mobilizes additional multilateral and bilateral financial assistance and provides the basis for both official and commercial debt rescheduling.

holding out for economic adjustments spread out over 18 months, instead of the 12 months sought by the IMF. In the fall of 1986, during a whirlwind tour of West European capitals, Mubarak extracted commitments from several governments to back Egypt's position on economic reform. By emphasizing the danger to political stability posed by a too rapid movement toward reform, the Mubarak regime mobilized the support of major donor countries for what we believe is a fairly modest reform program.

25X1

25X1

Secret

Secret

The primary components of the program include, according to Embassy reporting:

- A commitment to reduce the budget deficit, which in FY 1985 stood at 22 percent of GDP, by 2 percentage points a year until it falls to 5 percent of GDP. The FY 1988 deficit target is 13 percent of GDP.
- Merging of the commercial bank exchange rate with the free market rate over a period of 18 months largely to facilitate greater government access to expatriate hard currency earnings.
- Price increases in the energy, industrial, and agricultural sectors, including a 29-percent hike in electrical rates that went into effect in May 1987.
- Restrictions on bank lending.
- Increasing net international reserves by \$300 million to facilitate exchange rate unification.

Assessing the Reform Program

The measures Cairo has agreed to undertake represent important steps toward redressing serious economic distortions, but we believe the proposed adjustments do not go far enough and will not bring change rapidly enough to eliminate a large and potentially growing unfinanced gap in Egypt's foreign payments. The excruciatingly slow Egyptian bureaucratic process and a reluctance by the regime to stir up domestic problems appear likely to lead to even further procrastination and loss of critical momentum.

Exchange rate reform will be incomplete without additional important steps. In May 1987, Egyptian officials introduced a new exchange rate designed to closely track the free-market rate. The new rate—as of June £E 2.18 per US \$1—applies to remittances by workers abroad, tourism, and goods that make up about 40 percent of Egyptian imports, according to Embassy reporting. Over the remaining period of the standby program most other exchange rate transactions are to be gradually adjusted to this new rate. Currency reform as envisaged by Cairo, however, will fall short of full exchange rate unification. A number of important commodities, including oil exports and imports of several politically sensitive food items such as wheat, will remain convertible at the artificially low central bank rate of £E 0.70 per US \$1.

The partial unification has proceeded smoothly, but important hurdles remain. The government's crack-down on private foreign exchange dealers, which has included both threats and arrests, appears to have delayed the large-scale reentry of currency dealers into the foreign exchange market. It may prove difficult for the regime to continue its tight hold on these entrepreneurial operations. Continued harassment by the regime may only succeed in driving black-market operations further underground and encourage additional depreciation of the Egyptian pound. This, in turn, may lead to renewed diversion of foreign exchange from banking channels and could leave the government once more defending an artificial exchange rate. The regime's suppression of the private foreign exchange market may also deprive the vibrant and important private sector of its primary sources of trade financing. Unless the government allows the dealers a share of the market, foreign exchange shortages are likely to have a strong negative impact on private-sector production.

25X1

25X1

The government's decision to adjust the new rate administratively, rather than allowing it to float, will also complicate efforts to maintain parity with the free market rate. According to Embassy reporting, a new committee, consisting of representatives from commercial and public-sector banks and including nonvoting government representatives, has been tasked with maintaining a competitive exchange rate. Their exchange rate setting thus far has not varied by more than a few piasters (100 piasters=1 Egyptian pound) from the free market rate, but the committee may find itself over the next few months pressed by the government to resist further depreciations of the pound, particularly if inflation heats up. Given past Egyptian experience with bankers' committees setting exchange rates, such a development is a distinct possibility.

25X1

25X1

We believe the various parts of the economic adjustment program lack mutually reinforcing elements and thus will not lead to a sustained improvement in economic performance. For example, exchange rate reform should be linked, as the IMF strongly recommended, to substantially higher domestic interest

25X1

Secret

rates. This would help attract foreign currency accounts held abroad back into the domestic money supply, where these funds could be tapped to generate investment.⁴ Cairo, however, has remained noncommittal on the issue of interest rate hikes. The regime's commitment to integrated reform of the agricultural and industrial sectors also appears weak and unfocused. []

Finally, we share the concern expressed by IMF officials and others that the vague commitment of Egyptian officials to further reforms does not augur well for a successful adjustment program. The Egyptians have argued that the terms of the standby specify that information on additional reforms need only be made available at the first review of the program in September 1987. This suggests Cairo's willingness to consider a sustained program of reform may have dissipated with the implementation of the minimum measures necessary to win approval of the standby and achieve debt rescheduling. Unless the Egyptian Government commits itself to such a program, most financial observers agree the measures introduced to date will not lead to significant reductions in the country's foreign payments deficit—nor will they lead to sustained economic growth. []

Can Egypt Muddle Through? Key Variables

The Egyptian economy has remained sufficiently robust to preclude major disruptions in economic activity. Cairo has benefited from a number of factors that have postponed a foreign payments crisis and that together have allowed Egypt to muddle through. Much of the adjustment necessary to compensate for the drop in Cairo's foreign exchange earnings has come in the form of a continued large rise in external debt arrears that are now approaching \$1.5 billion. The majority of Egypt's external liabilities are in the form of official debt owed to countries and multilateral institutions. Largely for political reasons, these countries and institutions have reluctantly allowed Egypt to build up arrears in its debt servicing without

incurring any penalty in the form of a drastic cutoff in credit lines. To be sure, credit lines have shrunk, but Cairo, unlike many other debtor nations, does not face the problem of large outstanding debts to foreign commercial banks. []

Foreign benefactors, principally Saudi Arabia and Kuwait, have also provided significant new financial assistance. This aid []

[] has totaled about \$1 billion since the third quarter of 1986. Cash assistance from these sources has been vital in helping Cairo meet some of its more pressing external financial obligations over the past year. []

Egypt also has benefited from a rebound in oil prices. From a low of \$7 per barrel in August 1986, average Egyptian crude oil prices have increased to about \$17 per barrel today. Currently, the government's share of total exports is about 190,000 barrels per day, yielding revenues of about \$98 million monthly from crude sales alone. Although oil earnings are less than 60 percent of what they were before January 1986, when prices began to fall precipitously, they represent a significant jump from cash inflows during the third quarter of 1986 when, in some months, revenues fell to as low as \$10 million. []

Cairo also has been forced to take measures that have helped indirectly to ease the shortage of foreign exchange. Even before the exchange rate reform of May 1987, the government tacitly approved a selective devaluation. With official sources of foreign exchange no longer adequate to support food imports, the Ministry of Supply and Internal Trade last fall began allowing private-sector importation of most food items normally purchased only by the government and provided to the public at subsidized rates. In addition, by early 1987 most public-sector companies were permitted to obtain essential industrial imports at the free market rate. These measures were taken only on an interim basis, but they had the effect of easing considerably the pressure on official foreign currency reserves as well as preventing the Egyptian economy from suffering crippling shortages. []

⁴ Recently, the Egyptian Government has focused on what it believes is a large pool of savings (perhaps \$50-70 billion) held abroad by Egyptians that could be tapped to help finance its foreign payments deficits. The low domestic interest rate for Egyptian pound deposits and the lack of profitable domestic investments discourage such transfers. []

25X1

25X1

25X1

25X1

25X1

25X1

25X1

25X1

25X1

25X1

Secret

Table 1
Egypt: External Debt, 1981-86 ^a

Million US \$

	1981	1982	1983	1984	1985	1986 ^b
Total ^c	25,038	28,884	31,452	34,895	38,229	40,000
Medium- and long-term public and publicly guaranteed debt	21,864	24,442	27,071	30,116	33,263	33,822
Suppliers' credits	7,115	7,230	7,480	7,780	8,000	8,000
Financial institutions (including bonds)	726	767	862	843	794	710
Multilateral loans	3,657	3,752	4,022	4,423	4,724	5,077
IBRD	480	578	672	834	981	1,058
IDA	352	452	574	720	771	821
GODE	2,210	2,215	2,310	2,405	2,500	2,595
IMF Trust Fund	243	201	194	176	147	127
Use of fund credit	137	76	52	51	44	35
Other	235	230	220	237	281	441
Bilateral loans	10,456	12,693	14,707	17,070	19,745	20,035
West Germany	602	577	573	608	703	812
Japan	552	557	578	628	635	710
Kuwait	1,210	1,259	1,304	1,347	1,386	1,425
Saudi Arabia	1,037	1,057	1,079	1,106	1,130	1,154
United States	4,248	5,813	7,118	8,616	9,872	10,112
Other	2,807	3,430	4,055	4,765	6,019	5,822
Short-term debt	3,174	4,442	4,381	4,779	4,966	6,178

^a Data for fiscal period ending on 30 June of the stated year.^b Estimated.^c Disbursed and outstanding, including principal and interest in arrears.

We believe Egypt will be able to muddle through the next year without a financial crisis but at the price of substantially higher inflation—probably in the 50-percent range. At least two of the following conditions will have to be met to maintain financial stability:

- Implementation of the standby program proceeds smoothly without major backtracking by Egypt.
- International oil prices remain near current levels.
- Gulf Arab states continue to provide foreign payments assistance.

The likelihood that all three conditions will be met is considerably greater than even.

Although trouble-free implementation of the standby program is unlikely, Egypt probably will remain in

formal compliance with it. We believe the Mubarak government's resolve to comply with the terms of the standby would waver in the face of perceived threats to political order. If the Egyptians renege on some of their standby obligations or, even more likely, balk at implementing further reforms, the IMF could declare Cairo no longer in compliance. Such a move would cut off further disbursements of IMF funds and complicate efforts to move ahead with economic reform. This outcome is unlikely, given the strong pressure Western donors would exert on both the IMF and Egypt to maintain the program. More likely would be a breakdown in the IMF-Egyptian dialogue, short of a

25X1

25X1

**Egypt's Unofficial Economy—
Can It Provide a Critical Cushion?**

A large and active unofficial economy buttresses living standards for a wide spectrum of the Egyptian population. This unofficial sector includes foreign exchange, trade financing, and investment transactions, as well as employment activities unrecorded by the government. Hard data are generally lacking, but the unofficial economy includes a diverse assemblage ranging from Cairo cab drivers to large and powerful Islamic financial institutions that reputedly control a large share of the foreign currency market in Egypt. Remittance earnings funneled through private foreign exchange dealers, illegal money, and private earnings in the tourist trade provide the principal sources of funds. Much of these earnings, at least \$7-8 billion, are deposited in foreign currency accounts of the domestic banking system and provide an additional source of funds the government could tap if critically pressed for hard currency. These funds probably would be used sparingly by Cairo, since such utilization could spark massive capital flight.

The unofficial economy, in our opinion, will continue to function as an important safety valve, supplementing low average "official" incomes and providing access to goods and services otherwise unobtainable. It is unlikely that government intervention can seriously impede the workings of this vibrant and largely undocumented component of Egypt's economy. Private-sector service activity, largely synonymous with

the unofficial economy, may represent the most important component of personal income for a majority of urban Egyptians.

Nevertheless, it would be misleading to assume that the unofficial economy can neutralize the effect of cutbacks in government-subsidized goods and services. According to US Embassy estimates, 90 percent of Egyptians benefit from the extensive welfare system provided by the government. More important, from what we know about the low pay and fixed incomes of government and public-sector workers who make up a third of the labor force, subsidized goods and services constitute a critical element in their living standards. Many of these workers, according to informed observers, already depend on unofficial second and third jobs to make ends meet. Their flexibility to deal with cutbacks in subsidies may already be low. Private Islamic welfare organizations, according to Embassy reporting, have begun to play a larger role in the distribution of food and other essential goods to low-income urban groups, but it is unclear just how widespread and systematic their efforts are. On balance, the role of the official economy in maintaining living standards for a broad segment of the Egyptian population is unlikely to be displaced any time soon.

formal suspension of the program, which could delay further disbursements of multilateral assistance and heighten investor concerns that the economy was adrift.

If, by the first review of the standby in September 1987 the Egyptian political decisionmaking process is bogged down and agreement over further reforms is not possible, continuation of the economic adjustment program would be jeopardized. Prime Minister Sedky, though stronger and more assertive than his predecessor, may lack the political clout to push economic

reform measures forcibly, according to Embassy sources. Strong resistance from other powerful Cabinet ministers as well as Mubarak's failure to establish clear lines of responsibility appear largely to blame. The possibility of Egyptian decisionmaking paralysis is less than even, given the considerable pressure both Cairo and the IMF will be under to achieve some economic progress. Nevertheless, a breakdown in the IMF-Egyptian dialogue as a result of decisionmaking paralysis at the Cabinet level cannot be ruled out.

Secret



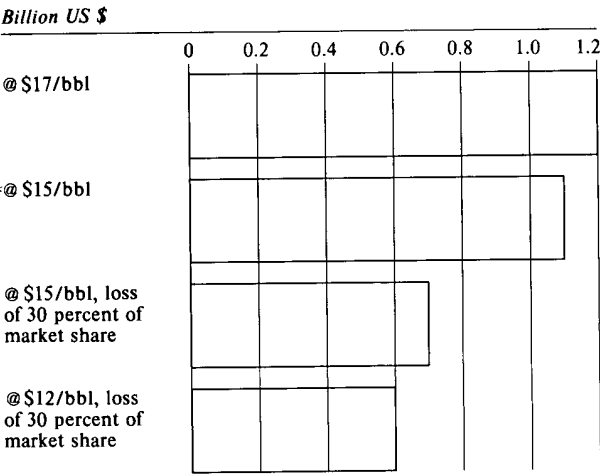
Khan Khalili market in Cairo: a major center of Egypt's informal money exchange network.

Another variable that would adversely affect Egypt's near-term economic outlook would be a substantial decline in world oil prices. Although it is unlikely that the oil market will weaken over the next six months, oil prices are a factor that must be considered in any analysis of Egypt's economic prospects. The effect of a drop in price of \$2 per barrel over the next year would involve roughly a \$140 million drop in earnings at current export levels—significant, but not catastrophic, in terms of revenue. A greater danger resulting from falling oil prices, in our view, is Egypt's seeming inability to market oil successfully in a soft market. This could result in far greater oil revenue losses and is exactly what occurred during the summer of 1986 when the Egyptian oil-price-setting committee failed to maintain competitive prices. The same pricing mechanism continues to determine Egyptian oil sales today.

We do not expect a cutoff in cash assistance from the Arab Gulf states. Renewed concern by these countries about Egypt's economic plight together with improved political ties should ensure their support. An inverse relationship may exist in the sense that assistance from this quarter is likely to grow as other revenue sources falter.

There are limits, however, to Arab largess. These countries' generosity may decline if oil prices weaken

Figure 2
Egypt: Petroleum Revenues Under Various Assumptions, 1988^a



^a Data for fiscal period ending in June.

313401 7-87

again or if expansion of the Iran-Iraq war threatens oil exports. A termination of the standby program resulting from Egyptian intransigence might also make their support more conditional. On balance, however, the probability is high that Gulf Arab support will continue at or near current levels.

Outlook and Domestic Consequences

The most likely scenario for the next year, in our opinion, is cautiously optimistic. Oil prices are likely to remain stable at approximately \$17 per barrel. We also expect that disbursement of the funds tied to the standby mechanism will continue despite difficulty in agreeing on further economic reforms. Gulf Arab money together with possible additional cash assistance from the United States will continue to narrow the financial gap.

Secret

Secret**Table 2**
Egypt: Foreign Payments, 1985-88 ^a*Billion US \$*

	1985	1986	1987	Scenario 1 ^b 1988	Scenario 2 ^c 1988
Current account balance	-3.0	-3.8	-2.8	-1.9	-2.4
Trade balance	-8.1	-7.8	-7.6	-7.5	-8.0
Exports	3.3	2.3	2.4	2.5	2.0
Oil	2.2	1.1	1.2	1.2	0.7
Nonoil	1.1	1.2	1.2	1.3	1.3
Imports	11.4	10.1	10.0	10.0	10.0
Service balance	3.7	3.1	2.9	4.7	4.7
Receipts	8.2	7.2	7.3	8.7	8.7
Suez Canal tolls	1.0	1.1	1.1	1.2	1.2
Tourism	0.9	1.3	1.4	1.5	1.5
Remittances	4.0	3.0	3.0	4.0	4.0
Investment income	0.9	0.7	0.7	0.8	0.8
Other	1.4	1.1	1.1	1.2	1.2
Payments	4.5	4.1	4.4	4.0	4.0
Interest	1.2	1.3	1.5	1.0 ^d	1.0
Other	3.3	2.8	2.9	3.0	3.0
Official transfers	1.4	0.9	1.9 ^e	0.9	0.9
Capital account	0.7	0.8	0.9	1.1	1.1
Financing gap	-2.3	-3.0	-1.9	-0.8	-1.3

^a Data for fiscal period ending 30 June of the stated year. Data are CIA estimates.^b Scenario 1 reflects oil sales at \$17 per barrel and at current export levels.^c Scenario 2 reflects oil sales at \$15 per barrel and a loss of market share equivalent to 30 percent of current export levels.^d Rescheduling of interest payments.^e Reflects approximately \$1 billion in Gulf Arab grants plus other transfers.

Under this scenario, crippling shortages are likely to be avoided, though growth in the economy will be impeded by import constraints, particularly within the public-sector industries. Living standards for middle- and lower-middle-income groups, adjusted for inflation, are likely to decline, although we suspect they will remain stable enough to preclude major outbreaks of political unrest. Reforms combined with economic forces already at work in the economy may push annual price increases for noncontrolled goods to 50 percent or more.

Low-income urban groups are unlikely to face a major decline in living standards. The prices of essential food commodities such as bread, sugar, cooking oil, and rice—primary components of low-income diets and budgets—are unlikely to change much. In our opinion, neither the Mubarak government nor any successor regime would risk tampering with these jealously guarded subsidies.

25X1

25X1

25X1

Secret

Secret

In a less likely worst case scenario, oil prices would slip gradually to \$15 per barrel, and renewed marketing difficulties would lead to a plunge in oil revenues—by 30 percent or more. Egyptian foot-dragging over implementing additional reforms would lead to a suspension of the IMF-endorsed standby program and a corresponding cutoff in IMF and other multilateral funding. Arab and US assistance would compensate for some of the resulting financial shortfall but would be limited by budgetary constraints as well as political constraints associated with Egypt's withdrawal from the program. []

Under these circumstances, financial shortfalls could become severe enough to induce widespread shortages. Food imports, a priority, would be maintained at or near normal levels, but a scarcity of intermediate and capital goods would cripple production in public-sector industries. The normally buoyant private sector also would feel the pinch caused by government import controls. Inflation would soar to an annual rate of 80 percent or more for noncontrolled goods, including many food items. Middle- and lower-middle-income groups would be hit hard, particularly public-sector employees and government civil servants on fixed incomes. Even the lower classes would begin to feel the crunch as subsidies on basic commodities are lifted. []

In the worst case, organized union demonstrations within the public-sector industries, as well as more violent uncontrolled wildcat strikes, would grow in frequency and intensity. According to the US Embassy, there appears to be a growing split between government and union leaders over trade union control, and enforced government austerity would alienate union leaders and members. Street demonstrations by hard-pressed civil servants would also be likely. Low-class elements could vent their frustrations in the form of spontaneous rioting. []

In this scenario radical Islamic elements might infiltrate these protests and seek to induce or aggravate violent confrontations. The government, through the security forces and the military, could reestablish order, at least through the next year, but there is a

long-shot possibility of a continuing spiral of repression, further violence, and mounting political opposition. []

Implications for the US-Egyptian Relationship

Even in an essentially trouble-free scenario, Egypt probably faces a sizable financing gap of \$800 million over the next year. In a worst case scenario, the gap could easily exceed \$1 billion. A portion of this deficit could be met by reducing imports, but at the risk of worsening shortages and lower growth. Arab assistance could conceivably close the gap, but we believe that Egypt will continue to turn to the United States for additional cash support. A high-level Egyptian official informed the US Embassy that Cairo will seek \$250 million in cash transfers in FY 1988 and another \$250 million in the following fiscal year. In the absence of US legislation providing for supplemental assistance, the cash component of Economic Support Funding (ESF), currently \$115 million annually, would probably have to be increased by diverting funds earmarked for the project assistance portion of ESF administered by the Agency for International Development. []

There will be important policy implications for the United States even if Arab assistance to Egypt materializes in sufficient quantity to obviate the need for additional US cash support. A large jump in Arab aid without significant corresponding increases in US assistance could strengthen the hands of those within the regime, such as Minister of Planning and International Cooperation Ganzouri, who favor putting distance between Egypt and the United States. We doubt that such a development would lead to a fundamental reappraisal by Cairo of its ties to the United States, but it could produce a more independent stance by Egypt on some bilateral and multilateral issues. []

Given the strains on Egypt's finances, the Foreign Military Sales (FMS) debt relief issue will remain a strong negative factor in US-Egyptian relations. Despite significant concessions by Washington, Cairo is

25X1

25X1

25X1

25X1

25X1

25X1

Secret

Secret

Egyptian-Soviet Relations: On the Mend

The agreement in April 1987 rescheduling Egypt's repayment of Soviet military debt represents a significant milestone in Soviet-Egyptian relations. In effect, Egypt's entire military debt to the USSR, previously valued at \$2.5 billion, was reduced, using a different exchange rate formula, to about \$500 million. This amount is to be repaid over 25 years at no interest and after a six-year grace period. Repayment will be in goods, not hard currency. The accord paves the way for expanded bilateral trade and a possible resumption of Soviet military equipment sales.

According to US Embassy sources in Cairo, the agreement resulted much more from a Soviet willingness to provide important concessions than from an Egyptian predisposition to improve relations. Moscow's initiative was probably designed to smooth bilateral ties and pave the way for greater Soviet activism in the Middle East. From Cairo's perspective the accord provides little in the way of immediate tangible benefits. Egypt was not servicing its Soviet military debt, and the agreement does not provide for foreign payments assistance.

More important, however, Mubarak probably views the agreement as valuable in terms of future benefits. Cairo will look to the Soviet Union as an important supplier of raw materials (for example, timber and steel) and will also seek Moscow's assistance in updating its aging Soviet weapons inventory and factories. The accord almost certainly will be cited by Cairo as an example of effective military debt restructuring to press the United States to provide more favorable terms on FMS debt relief.

pressing for further relief on \$4.5 billion in military debt owed to the United States. Paris Club debt rescheduling associated with the standby program includes FMS loans, but it is unclear whether the Mubarak regime will accept less than a separate accord on FMS. According to Embassy reporting, for Mubarak the issue has come to symbolize the extent of the US commitment to Egypt.

The Egyptians will continue to harbor exaggerated expectations that Washington can control the outcome of deliberations by international financial institutions. If the Egyptian-IMF dialogue breaks down during the next year as austerity and inflation work their way through the economy, Cairo will be under pressure to ease and/or delay reform. Should this happen, Cairo would almost certainly urge the US Government to use its influence to convince the IMF to accommodate the Egyptians, despite their foot-dragging. The further politicizing of the Egyptian-IMF accord, though perhaps necessary in a worst case, would impose costs on US relations with the IMF and would establish troubling precedents for US dealings with other Third World countries.

Finally, the US-Egyptian relationship will continue to be strained by the linkage of US economic assistance to Egyptian performance in implementing reform. The need for US policymakers to expend time and influence in cajoling, pressing, and prodding Cairo to take more timely and effective measures to correct its economic problems probably will continue over the next several years. To date, Cairo has tolerated US prodding as the price of obtaining additional financial support. If the Mubarak regime backs away from reforms, however, or refuses to implement additional measures for fear of inciting political unrest, such US pressure almost certainly would become counterproductive. In the worst case, an outbreak of domestic violence could provoke Mubarak to attempt to protect his political flanks by lashing out at foreign scapegoats—the United States and the IMF—for pressing Egypt to accept austerity.

25X1

25X1

25X1

25X1

25X1

25X1

Secret

Secret

Secret